Franchise Tax Board

SUMMARY ANALYSIS OF AMENDED BILL

Author:	Lara	Analyst:	Jessica Deitchman	Bill Number:	SB 567
Related Bills:	See Prior Analysis	Telephone:	845-6310	Amended Date	May 15, 2017
		Attorney:	Bruce Langston	Sponsor:	

SUBJECT: Changes to Charitable Reminder Trusts/Eliminate Step-up in Basis/Cap Deduction for Highly Compensated Executives Pay at $1,000,000

SUMMARY

This bill would do the following:

Provision No. 1: Modify the definition of a Charitable Remainder Annuity Trust (CRAT)

Provision No. 2: Eliminate the “step-up” in basis for inherited property for certain taxpayers

Provision No. 3: Cap the Deduction for Highly Compensated Executive Pay at $1,000,000

The bill would make a number of non-substantive technical changes, and express legislative intent to enact legislation for taxable years beginning on or after January 1, 2017, to modify the way payments are taxed to related parties, as defined in Section 267, 318, or 707 of the Internal Revenue Code.

RECOMMENDATION – NO POSITION

SUMMARY OF AMENDMENTS

The May 15, 2017, amendments modified the operative date for the CRAT and executive pay provisions, and adopted a technical amendment. As a result of the amendments, one of the implementation considerations and one of the technical considerations in the department’s analysis of the bill as amended May 5, 2017, have been resolved. Except for the “Effective/Operative Date,” “This Bill,” and “Economic Impact” sections relating to those two provisions, the remainder of that analysis, still applies. The “Implementation Considerations,” “Technical Considerations,” “Fiscal Impact,” “Economic Impact,” and “Policy Concerns” sections for each remaining provision have been restated for convenience.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately. The specific operative dates of the provisions vary and are addressed separately below.

ECONOMIC IMPACT – SUMMARY REVENUE TABLE ($ in Millions)

Fiscal Year	2017-18	2018-19	2019-20
Provision No. 1: Modify the Definition of a Charitable Remainder Annuity Trust	**See Economic Impact Section below**	**See Economic Impact Section below**	**See Economic Impact Section below**
Provision No. 2: Eliminate the Step-up in Basis for Inherited Property for Certain Taxpayers	**+ $1.0**	**+ $3.9**	**+ $7.9**
Provision No. 3: Cap the Deduction for Highly Compensated Executive Pay at $1,000,000	**+ $35**	**+ $90**	**+ $100**
$ In Millions Total	**+ $36**	**+ $112.9**	**+ $107.9**

PROVISION NO. 1: Modify the Definition of a CRAT

OPERATIVE DATE

This provision would be specifically operative for a CRAT formed on or after January 1, 2018.

THIS PROVISION

This provision would, under the Personal Income Tax Law (PITL), for a CRAT formed on or after January 1, 2018, modify the definition of a CRAT by increasing the remainder value of the trust required to be contributed to charity from at least 10 percent to at least 40 percent of the initial net fair market value (FMV) of all property placed in the trust.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

FISCAL IMPACT

The department's costs to implement this provision have yet to be determined. As the bill moves through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of SB 567 Provision No. 1: Modify the Definition of a CRAT As Amended May 15, 2017 For CRATs Formed On or After January 1, 2018 Assumed Enactment After June 30, 2017 ($ in Millions)		
2017-18	2018-19	2019-20
a/	a/	a/

a/ The estimated revenue impact of increasing the remainder interest from at least 10 percent to at least 40 percent, would be a revenue loss, but the amount is unknown.

This analysis does not account for changes in employment, personal income, or gross state product that could result from this provision.

Revenue Discussion

When a CRAT is set up, the donor of the assets to the trust is allowed a charitable contribution deduction in the year of the contribution of the asset for the present value of the remainder interest. The revenue impact of this proposal would be dependent upon the FMV of the donation in the year of the contribution. In determining the FMV of the charitable contributions to a CRAT, the FMV of the contribution is reduced by the present value of the CRAT's annuity payments.

The Franchise Tax Board does not have the tax data necessary to calculate the value of the annuity payment or the value of the remainder interests. However, it is probable this provision would result in a net revenue loss as CRATs formed on or after January 1, 2018 would have the means to structure their charitable contributions to meet the minimum remainder requirements. This would increase the total charitable deductions claimed resulting in a net revenue loss.

POLICY CONCERNS

This provision would require specific rules for CRATs for which federal law has no counterpart, thus increasing nonconformity.

PROVISION NO. 2: Eliminate the Step-up in Basis for Inherited Property for Certain Taxpayers

THIS PROVISION

Under the PITL, this provision would, for property acquired or inherited from decedents who died on or after January 1, 2018, preclude a “step-up” basis adjustment and require the use of the decedent’s carryover basis for individuals with adjusted gross income in the taxable year of the decedent’s death of:

- $2,000,000 or greater in the case of a joint return or surviving spouse,
- $1,500,000 or greater in the case of a head of household, and
- $1,000,000 or greater for all other filers.

Under the Corporation Tax Law (CTL), persons other than individuals, with total income of $1,000,000 or greater for the taxable year of the decedent’s death, would be precluded from utilizing the step-up basis adjustment.

In addition, for both the PITL and CTL, the basis of property acquired or inherited from decedents who died on or after January 1, 2018, would no longer be increased for any federal estate tax paid on the property.

IMPLEMENTATION CONSIDERATIONS

This provision uses terms that are undefined, i.e., “total income” and “taxable year of the decedent’s death.” The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of this provision. For clarity and ease of administration, it is recommended that the bill be amended.

FISCAL IMPACT

The department’s costs to implement this provision have yet to be determined. As the bill moves through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

This provision would result in the following revenue gain:

Estimated Revenue Impact of SB 567 Provision No. 2: Eliminate the Step-up in Basis for Inherited Property for Certain Taxpayers Assumed Enactment After June 30, 2017 ($ in Millions)		
2017-18	2018-19	2019-20
+ $1.0	+ $3.9	+ $7.9

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

This revenue estimate is based on the proration of the Joint Committee on Taxation's (JCT) federal tax expenditure estimate for the personal income tax exclusion of capital gain at death JCT did not score this exclusion for corporations). In January 2017, the JCT estimated the federal revenue impact of the exclusion to be $35 billion in 2018. To determine California's share of the federal loss, federally reported data was used to calculate that 14 percent of nationally reported capital gain income was from California, then federal and state tax rates were analyzed to estimate a federal/state tax rate adjustment of 53 percent, resulting in an estimated revenue impact of $2.6 billion. It is assumed that 20 percent, or $525 million by value, of estates would be settled in the year of death, 30 percent in the year following, and the remainder over the next five years. Of the amount settled in the year of death, it is assumed that 2 percent, or $11 million, would be inherited by taxpayers that would no longer be allowed to step-up the basis in their inherited property. When property is inherited, it may be sold in the year inherited, the next year, or any other year after that (or potentially never). For purposes of this estimate, it is assumed 15 percent of inherited property would be sold in the year the property is received and a small percent would be sold each year thereafter, or potentially never sold, resulting in $1.7 million in estimated revenue gain in taxable year 2018, $5 million in taxable year 2019, $10 million in taxable year 2020, and increasing each year thereafter.

The calendar year estimates are converted to fiscal years and then rounded to arrive at the amounts shown in the above table.

PROVISION NO. 3: Cap the Deduction for Highly Compensated Executive Pay at $1,000,000

OPERATIVE DATE

This provision would be specifically operative for taxable years beginning on or after January 1, 2018.

THIS PROVISION

This provision would modify existing federal conformity to the deduction limitation on excess compensation for highly compensated executives. Exceptions for commissions, other performance-based compensation and compensation payable under a written binding contract would not apply under state law.

FISCAL IMPACT

The department's costs to implement this provision have yet to be determined. As the bill moves through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue gain:

Estimated Revenue Impact of SB 567 Provision No. 3: Cap the Deduction for Highly Compensated Executive Pay at $1,000,000 As Amended May 15, 2017 Assumed Enactment After June 30, 2017 ($ in Millions)		
2017-18	2018-19	2019-20
+ $35	+ $90	+ $100

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

This revenue estimate is based on a proration of the Economic Policy Institute's (EPI) estimate for the deduction of executive compensation. Using EPI data, the estimated federal impact of the deduction for executive performance-based compensation would be $6.4 billion in 2018.

To determine the impact on California, nationally reported data was used to calculate that 7 percent of federal income was from California. The estimate was then reduced by 74 percent to reflect the differences between federal and state tax rates for a total of $117 million. It is assumed that the reduced deduction amount would be offset by a 25 percent increase in the usage of net operating losses and California credits available, resulting in an estimated revenue gain of $90 million in 2018.

The tax year estimates are converted to fiscal years and then rounded to arrive at the amounts shown in the above table.

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